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ABSTRACT

In 1969, in a report to The Ford Foundation entitled "The Law and the Lore of Endowment Funds," William L. Cary and Craig B. Bright summarized the results of an extensive survey of the law governing college and university endowment funds. The key conclusion of the report is that "there is no substantial authority under existing law to support the widely held view that the realized gains of endowment funds of educational institutions must be treated as principal." This was critiqued by Thomas E. Blackwell and Ralph S. Johns (NACUBO Professional File, May 1970). The first article in this publication by Cary and Bright is a reply to the critique and deals primarily with the legal aspects of endowment funds and particularly with the question of whether capital gains on investments should be treated as principal or as income. The second article, by John F. Meck, is also a comment on the Blackwell-Johns article and presents the author's thoughts on the investment considerations involved, especially as they relate to the concept of total return. (JMF)

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FURTHER NOTES ON THE CONCEPT OF TOTAL RETURN

THE LAW AND THE LORE OF ENDOWMENT FUNDS: A REPLY TO THE CRITICS

By William L. Cary and Craig B. Bright

TOTAL RETURN AND COLLEGE AND UNIVERSITY INVESTMENTS: A COMMENT

By John F. Meck

THE MAY, 1970, issue of PROFESSIONAL FILE *was devoted to an article, "College Endowment Funds: A Consideration of Applicable Accounting and Legal Principles," in which the authors, Thomas E. Blackwell and Ralph S. Johns, challenged a central conclusion of a 1969 report to the Ford Foundation that "there is no substantial authority under existing law to support the widely held view that the realized gains of endowment funds of educational institutions must be treated as principal." The Ford report was* THE LAW AND THE LORE OF ENDOWMENT FUNDS *by William L. Cary and Craig B. Bright, who described therein what was becoming known as the total return concept.*

As was suggested by NACUBO in publication of the Blackwell-Johns article, the total return concept, although generally familiar to most business officers with responsibilities for investment management, deserves specific and detailed study in the context of institutional practice and pertinent law. In such study Messrs. Blackwell and Johns brought to bear an important point of view, and NACUBO, meantime, in institutional surveys and regional workshops, has helped foster wider understanding of total return. There has remained, however, the need to put into the record the further comments of persons closest to and most familiar with the evolution and impact of the total return concept.

This issue of PROFESSIONAL FILE *extends that record. NACUBO is pleased to present herewith the statement by Messrs. Cary and Bright, authors of the Ford report, and to have in addition the further note by John F. Meck, of Dartmouth College, one of higher education's most experienced investment managers and consultants and Chairman of the NACUBO Investment Committee. These articles comprise a valuable contribution to the development of ideas important to institutions everywhere.*

THE LAW AND THE LORE OF ENDOWMENT FUNDS: A REPLY TO THE CRITICS

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A YEAR AGO, in a report to The Ford Foundation entitled *The Law and the Lore of Endowment Funds,* we summarized the results of an extensive survey of the law governing college and university endowment funds. A key conclusion of the report is that

> [T]here is no substantial authority under existing law to support the widely held view that the realized gains of endowment funds of educational institutions must be treated as principal. No case has been found which holds that such an institution does not have the legal right to determine for itself whether to retain all such gains or to expend a prudent part. We submit that there is no reason why the law should deny educational institutions that flexibility. [1]

A critique of the report and of that conclusion, by Thomas E. Blackwell and Ralph S. Johns, appeared in the May 1970 issue of this journal.[2] This is our reply.

At the outset let us stress the initial point of our report. We do not advocate the purchase of any particular type of security. Nor do we recommend either the expenditure or the preservation of capital gains. We are lawyers, not investment advisers. Messrs. Blackwell and Johns argue that

> A tax-exempt institution should purchase a growth stock only when it is convinced that its growth potential is sufficiently large . . . . It should sell it and invest the proceeds in higher income securities just as soon as its increment in market price justifies this action. [3]

The Question is Whether Legal Impediments Actually Exist

The soundness of such advice may be debated, but in any event it deals with a question our report made no attempt to answer—purposely. It is a matter of policy, not a matter of law. Rather, we attempted to determine whether the directors of an educational institution are circumscribed by the law or are free to adopt the investment policy *they* regard as sound for their institution, unhampered in their choice by legal impediments and restrictions.

It is probably true that one would feel less impelled to dispute the existence of alleged legal impediments if one assumed, with Messrs. Blackwell and Johns, that such impediments really have no significant impact on investment policy. In that connection they state that they "do not accept" the "argument" that educational institutions will forego investments in growth stocks if they are unable to expend capital gains.[4] Whether they accept it or not, of the 186 educational institutions with endowments having a market value of $3,000,000 or more which responded to our questionnaire, 50 per cent stated that their investment portfolios would be changed to include more growth stocks if they

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CRAIG B. BRIGHT is a partner in the New York law form of Patterson, Belknap & Webb and a lecturer on endowments. A graduate of Colgate University and of Harvard, where he won his J.D. degree in 1955, Mr. Bright is a member of the Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York. He is co-author of THE LAW AND THE LORE OF ENDOWMENT FUNDS

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were legally free to spend the capital gains of their endowment funds.[5] Such institutions have assumed that the law prohibits them from expending capital gains. One purpose of our report was to examine the validity of that assumption.

Our critics believe that all American jurisdictions can be classified neatly as following either the Doctrine of Absolute Ownership (the doctrine that educational institutions are the absolute owners of their endowment funds) or the Trust Theory (the theory that such institutions are trustees of their endowment funds). In their words,

> If the courts of this country had always been of the opinion that colleges, universities, and other charitable corporations hold their endowment and other restricted funds as trustees and not as absolute owners, no one could challenge the corollary that such endowment funds are, in fact, charitable trusts, to be administered in accordance with long-established concepts of the law of trusts.[6]

They dispute the Doctrine of Absolute Ownership and therefore conclude that trust law, in all its aspects, must be applied to the administration of endowment funds.

No Body of Law Solely Applicable

If one deals only in blacks and whites, the other colors of the spectrum can be ignored. But such oversimplification is unwarranted; frequently the law is neither black nor white. The fact is that *no* jurisdiction treats educational institutions solely as trustees, solely as absolute owners, of their endowment funds. In *every* jurisdiction the law governing charitable corporations is *sui generis,* drawing to some extent upon trust law and corporate law and contract law, depending upon the issue to be solved. The cases exist in abundance, and should be read with an open mind. We cited a number in our report, and commend them to the attention of those who are interested.

Messrs. Blackwell and Johns stress their concern that any attempt to change "practices currently in vogue" be made in a "procedurally sound manner.[7] We do not advocate the casual disregard of traditionalist views. As we said in our report,

> It is . . . true that it has been the traditional practice of most cautious administrators of educational endowment funds to classify realized gains as principal. To bring about a change in this practice will require some sort of affirmative action. . . .[8]

If the law is in doubt, the procedurally sound means of seeking clarification is through the courts and the legislatures. What can be more proper than the declaratory judgment of a jurisdiction's highest court, the procedure followed in the leading case of *St. Joseph's Hosp. v. Bennett* (on which we, and our critics, both rely)?[9] Or can we find any clearer expression of public policy than legislation? One example is New York's Not-for-Profit Corporation Law, which became effective September 1, 1970. It allows the directors of not-for-profit corporations to include in the income of endowment funds "so much of the realized appreciation of principal as the board may deem prudent," provided that the fair value of the principal, after such allocation, is not less than its fair value when received by the corporation.[10] While the law does not yet apply to educational institutions, it could easily be made to do so.

Restrictions Must Be Affirmatively Imposed

Procedure aside, perhaps the crux of our differences with Messrs. Blackwell and Johns lies in our approach to the law. We believe it to be fundamental that in a free society an institution is free to do as it chooses, unless society, for the promotion of the general welfare, has affirmatively imposed restrictions upon the institution's freedom of choice. As noted in our opening paragraph, neither we nor our critics have found any case anywhere in which a court has classified, as principal or income, the capital gains of the endowment funds of a charitable corporation, held by the corporation itself.[11] Statutes are almost wholly silent on the point,[12] and donors almost never give the slightest indication of how they wish capital gains to be treated.[13]

If the courts, and the legislatures, and the donors of the funds have all been silent, who imposed the restrictions Messrs. Blackwell and Johns assert? They point to a treatise entitled *College and University Business Administration* which espouses their ideas, and find it regrettable that The Ford Foundation did not see fit to support it.[14] They neglect to mention that Mr. Blackwell was the editor of the treatise in its early editions, and that Mr. Johns for years was the principal adviser to the publishers on accounting matters. They have looked upon their preconceptions and found them good, but surely they must agree that others—lawyers, and courts, and legislatures—are free to question their validity.

FOOTNOTES

1. W. Cary and C. Bright, *The Law and the Lore of Endowment Funds* 33 (1969) (the "Report").
2. T. Blackwell and R. Johns, "College Endowment Funds: A Consideration of Applicable Accounting and Legal Principles," NACUBO *Professional File* 1 (May 1970) (the "Critique").
3. Critique 5.
4. *Ibid.*
5. Report 6 note.
6. Critique 2.
7. *Id.* at 6.
8. Report 17.
9. 281 N.Y. 115, 22 N.E. 2d 305 (1939).
10. *N.Y. Not-For-Profit Corp. Law* § 513 (d) (McKinney 1970).
11. Critique 4.
12. Report 12-13.
13. *Id.* at 10-11.
14. Critique 6.

JOHN F. MECK, Vice President and Chairman of the Investment Committee of Dartmouth College, has been a student for years of investment law and policy and, as Chairman of NACUBO's Committee on Investment, has been a leader in continuing re-examinations of investment practices in higher education. A graduate of Dartmouth and holder of an LL.B. degree from Yale, Mr. Meck was admitted in 1937 to the New York State Bar, was associated with New York and Washington law firms, and taught at Yale Law School (and was Assistant to the Dean there) before entering Navy service in World War II. After the war he resumed the practice of law and was a Hoover Commission staff member. He was named Treasurer of Dartmouth in 1949 and Vice President in 1952. In 1970 he became Chairman of the Investment Committee of the Dartmouth Board of Trustees. He has been President of the Eastern Association of College and University Business Officers and he presently is serving a second term as a member of the NACUBO Board.

TOTAL RETURN AND COLLEGE AND UNIVERSITY INVESTMENTS: A COMMENT ON THE BLACKWELL-JOHNS ARTICLE OF MAY, 1970

By JOHN F. MECK
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THE ARTICLE on "College Endowment Funds," by Thomas E. Blackwell and Ralph S. Johns, in the *Professional File* for May, 1970, and the reply thereto by William L. Cary and Craig B. Bright which appears in this issue, deal primarily with the legal aspects of college and university "endowment funds" and particularly with the question of whether capital gains on investments should be treated as "principal" or as "income." In this comment I will not attempt to deal with the legal issue, but I do wish to present a few thoughts on the investment considerations involved, especially as they relate to the concept of "total return."

The principal investment comment by Messrs. Blackwell and Johns is contained in the two paragraphs of their article reading as follows:

> The entire thrust of the arguments presented by Messrs. Cary and Bright is that, unless colleges are permitted to expend a portion of their endowment capital gains, they must forego the advantage of investing in the common stock of companies with an attractive long-term growth potential. We do not accept this argument. By adherence to an appropriate diversification program, we believe that any investor who selects sound equities for their growth potential and who is wise enough to develop a rational investment cycle can increase both his principal and his annual income substantially.
>
> The investment committee of a college should recognize the fact that the market price of growth stocks is influenced by a strong demand for them by those in the upper tax brackets. A tax-exempt institution should purchase a growth stock only when it is convinced that its growth potential is sufficiently large to justify paying the premium wealthy investors feel compelled to pay. It should sell it and invest the proceeds in higher income securities just as soon as its increment in market price justifies this action.

The second of these two paragraphs, if it is read literally, is suspect on two counts. First, it claims that the main influence on the market price of growth stocks is the strong demand by "upper bracket" taxpayers. Conceding that this position may have been valid some twenty years or so ago, it clearly does not reflect the stock market of the 1960's and of today. In the past decade by far and away the strongest demand for growth stocks has been an institutional demand, and especially that of mutual funds and corporate and other pension funds, with the wealthy individual investor playing a much less significant role. This demand from mutual funds and pension funds has, of course, affected the market price of growth stocks, so to some extent the conclusion reached by Messrs. Blackwell and Johns may have merit, but not for the reason they assert.

Second and more serious is their argument in the last two sentences of the second paragraph quoted above. These set forth overly simple criteria for the buying and selling of growth stocks. Assuming that a college or university does decide that the growth potential of a particular stock "is sufficiently large to justify paying the premium," Messrs. Blackwell and Johns then state, without qualification, that the growth stock should be sold and the proceeds reinvested in higher income securities "just as soon as its increment in market price justifies this action." At the very least this seems to be little more than advocating that growth stocks should be bought at their lows and resold at their highs.

Decisions are Difficult in Growth Stock Area

Every investment manager has the problem of making hard decisions, and decisions in the growth stock area are the hardest. They involve such questions as what is a growth stock, when should it be purchased, and when should it be sold? Messrs. Blackwell and Johns make these decisions seem relatively easy. Yet, for example, if an investment manager on December 31, 1957, decided that IBM at a price of 34 and at 31 times 1957 earnings still had some growth for the future and bought it for his college's portfolio, despite its low current yield of 7/10ths of 1 per cent, when should it be resold? A year later, at 62, when the multiple was 43x and the yield 5/10ths of 1 per cent? On December 31, 1961, at 150 and 63x and a yield of 4/10ths of 1 per cent? Or should he have retained it until December 31, 1969, when the price was 350, the multiple was down to 43x again, and the yield 1 per cent? By that time the compound annual total return over the twelve years would have been just over 22 per cent, of which about 21.5 per cent would represent appreciation, reflecting growth for the ten years of close to 800 per cent. The appreciation for the same period for a respectable "income stock," Allied Chemical, would have been only about 54 per cent.

It can be argued in rebuttal that the selection of IBM is unfair because it has had a very unusual growth record. However, the fact is that some colleges and universities did not buy IBM and many other growth stocks in the 1950's simply because they felt they could not justify owning a stock yielding less than 1 per cent. Further, a cross section of good quality growth stocks bought in 1957 would, on the average, have shown an appreciation and a total return greater than that on "income stocks."

The policy advocated by Messrs. Blackwell and Johns raises, moreover, unusually difficult problems in the situation of recent years when long-term bond yields at times have been over 9 per cent and income stock yields 5 to 6 per cent or even higher. In these circumstances would they advocate that a college or university should sell its growth stocks and reinvest in long-term bonds at 9 per cent with five or ten year protection against refunding at lower interest rates? To put the case in more extreme terms, would they argue that a portfolio should be invested today 100 per cent in bonds, selling income stocks as well as growth stocks, on the theory that such high yielding bonds should be held at least until the investment manager concludes either that the long-term interest rate outlook is such that the bonds will in fact be refunded at lower interest rates, perhaps 7 per cent, at the end of the protection period or that interest rates will rise to 10 per cent or higher and the 9 per cent bonds should be sold? In either case, rather precise timing would be called for, to say the least.

To document the fact that this problem is a real one, a few years ago, when interest rates were in the 6½-7 per cent range, a number of institutions made switches from growth stocks into long-term bonds to increase ordinary income. The institutions which still hold these bonds today will have substantial losses, because as interest rates rose, the 6½-7 per cent issues would have depreciated in value. They would still get their 6½-7 per cent on their original investment, but the possibilities of increasing this yield would be severely limited.

My purpose in making these comments is not to urge any particular investment policy or special formula but simply to emphasize that the problems of investing college and university funds are much more difficult than Messrs. Blackwell and Johns would lead one to believe. Very possibly they would have recognized the problems if their article had not been primarily on the legal aspects. But not having done so, the danger exists that their article may be misleading to many readers.

Policy Must Balance Present, Future Needs

Insofar as their thesis tolerates investment in growth stocks only in very limited situations, what then is the best long-term investment policy for a college or university? The answer must be that present needs for revenue must be measured against future needs and a balance struck between the two. In accomplishing this, the total return concept, to the extent that it frees a college or university from the constraint of seeking income in the ordinary meaning of dividends and interest, is certainly worth very careful examination. Moreover, it should be kept in mind that the total return approach is not necessarily confined to a portfolio consisting of growth stocks or even one of both growth and income stocks. If in the future long-term bond yields rise to 10 per cent or higher and protection against refunding is provided for longer periods than five to ten years, a portfolio could be operated on total return even though invested in long-term bonds. This would require utilizing for current needs only perhaps 5 per cent of the total yield with the balance of the total yield being reinvested.

There is one important omission from the article by Messrs. Blackwell and Johns. While their article is entitled "College *Endowment* Funds" (italics supplied), and while throughout the text the term "endowment" is carefully used, nowhere is it recognized that most colleges and universities also have quasi-endowment funds (also known as funds functioning as endowment). These are funds the principal of which is expendable either wholly at the discretion of the institution or for a use specified in the terms of the gift. At some institutions as much as 45 per cent of the total investment portfolios represent investments of these quasi-endowment funds. It is perfectly legal, and I believe Messrs. Blackwell and Johns would concede this, for an institution to adopt the total return concept for these quasi-endowment funds. Already a number of institutions are applying total return to this type of fund, Chicago, Stanford and Duke being three leading examples. Hence, for any institution with quasi-endowment funds, the possible use of the total return concept for this part of its investments portfolio is well worth consideration.

The final paragraph of the article by Messrs. Blackwell and Johns deals with the question of delegation of responsibility for investment decisions, the text reading as follows:

> If the courts should rule, as we believe they should and will, that educational and charitable corporations hold their endowments as trustees and not as absolute owners, it will not be possible for them to implement Mr. Barker's recommendations. The courts of equity have declared in unmistakable language that the most important responsibility of a trustee is the selection of securities for the investment of the corpus of his trust and that this responsibility cannot be delegated to others. A trustee may and should seek professional advice, but the final decision must be made by him.

The principal issue here is the legal question of whether a college or university or its governing board is required, in the investment of endowment funds, to look upon itself as a private trustee or trustees or as a corporation with the members of the board in the role of corporate directors. Messrs. Cary and Bright deal with this aspect in *The Law and the Lore of Endowment Funds*, pages 61-65. There is also involved, however, a very practical problem in terms of investment procedures and the attainment of the optimum investment results.

The paragraph quoted above is not clear as to whether Messrs. Blackwell and Johns view the institution itself as an individual "trustee" or the members of its governing board as the "trustees" (Note the use of the word "him" at the end of the paragraph.) If they mean to suggest that the members of a governing board of a college or university are "trustees," either individually or by participating in a board vote, would not each such "trustee" have to participate in each investment decision? As Messrs. Blackwell and Johns well know, this is impossible from a practical standpoint even for an institution with a relatively small board of ten or twelve trustees, let alone for a board with twenty-five to thirty-five members. Virtually every board of trustees at the very minimum delegates the selection of securities to an investment committee usually composed of from three to six members. A very widespread practice, moreover, is for the investment committee to delegate decisions which have to be taken between meetings to two or three members of the committee. Even this flexibility leaves something to be desired. Some institutions have met this problem by setting up approved lists for purchase and then authorizing the investment manager, whether within or outside the corporate structure, to buy securities on the approved list or sell securities in the portfolio, provided such transactions are promptly reported to the committee so that the committee may rescind the purchase or sale if it is dissatisfied.

Investment Decisions Now Usually Delegated

It is unfortunate that Messrs. Blackwell and Johns did not amplify the paragraph quoted above because it seems to prescribe a completely unreasonable and unworkable investment procedure which is wholly unsuitable under present-day conditions. Whether or not one agrees with the Barker Report on delegating investment decisions to professional investment managers (President Bowen's comment quoted by Messrs. Blackwell and Johns, that the Barker Report "may place too much emphasis on the mystique of the investment manager," has some merit), most reasonable men would agree that it is essential to have sound working procedures for buying and selling investments. The evidence today is that when the investment decision-making process requires agreement between the investment manager and the investment committee on the selection of individual investments, the result is a hodgepodge which usually will not produce first rate performance. Most important, it makes it virtually impossible to fix responsibility for poor or mediocre performance. For example, under this kind of set-up the performance results have to be measured not only in terms of securities actually bought and sold but also in the light of recommendations of the investment manager which the committee turned down, or even, in some cases, recommendations which would have been made except that the investment manager knew they would be rejected.

What is needed today, and there are increasing signs that this is beginning to take place, is the development of a new relationship between the investment manager and the college or university investment committee. These include the development of better criteria for the initial selection of an investment manager or managers, the diversification of investment managers by allocating a proportion of the portfolio to each of two or three different managers, and the recognition that, in general, the function of the investment committee is one of "overseeing" the work of the investment manager, "auditing" the manager's performance, and changing managers when the performance results are not satisfactory. Hopefully, within a few years this new relationship will be generally accepted throughout the college and university world.
